ASEAN BRIEFS

Taxing Ourselves to Prosperity: Some Proposal for More and Better Taxes

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The Habibie Center - ASEAN Studies Program ASEAN Briefs

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Executive Summary

This issue of ASEAN Briefs will attempt to explain the major problems currently facing developing nations-particularly middle-income ASEAN countries- in collecting taxes. We will also discuss the current state of income taxes, both personal and corporate, and the various problems associated with them. Finally, we will propose a few new taxes that the government can levy which has the potential to not just increase revenue but also correct market and regulatory failures. This issue of ASEAN Briefs will not aim to be comprehensive, but rather aims to familiarize readers with the current problems with tax policy and the various proposals to improve it.

Introduction:

Why We Can't Have Nice Things

"The fiscal history of a people is above all an essential part of its general history. An enormous influence on the fate of nations emanates from the economic bleeding which the needs of the state necessitates, and from the use to which the results are put."

– Joseph Schumpeter, The Crisis of the Tax State (1918)

Everyone wants something from the government. One can find more than a lifetime's worth of *cris de coeur*from international organizations, businesses, NGO's, and passionate individuals calling upon ASEAN governments to do *something.* Many have asked the government to invest in new internet infrastructure, spend more on education, provide free health-care, or enact a universal basic income.

The problem with most policy recommendations is that they are requests to the government to do something that inevitably requires moneywhile keeping silent on how to acquire that money (or sometimes even asking the government to stop taking their money). If it is difficult enough for developed countries to fulfill the wishes of all of its citizens, the limited tax intake of developing countrieslimits their governmentsability to provide public services to their people, even the most essential ones.

This issue of ASEAN Briefs will attempt to answer why developing countries such as those found in ASEAN have such limited tax revenues, wadeinto the discussion of income taxes,and provide certain measures that ASEAN governments can do to increase said revenues. We shall not discuss how these extra revenues should be used -as ideas to spend money are abundant- and will only try to acknowledge the political feasibility of such measures. What this issue of ASEAN Briefs will focus on specifically is to study the various ways lower and middleincome economies -specifically in the ASEAN region- can expand their government budget with the only other considerations being whether or not said revenue increasing measures would distort economic efficiency and whether the burden of these measureswill be sufficiently progressive to decrease inequality (progressive being jargon where the better-off pays proportionately more than the less well-off)[1]. Some of the measures proposed here will also be useful in correcting market and regulatory failure in addition to having the potential to add to revenue.

1 This being said, tax-burden progressivity is not necessary for a tax to have a net progressive effect, but rather it is how such extra revenues are then spent that decides its effects on inequality.

The Difficulty of Tax Collection

Tax Administration: Let's not Tax the Poor
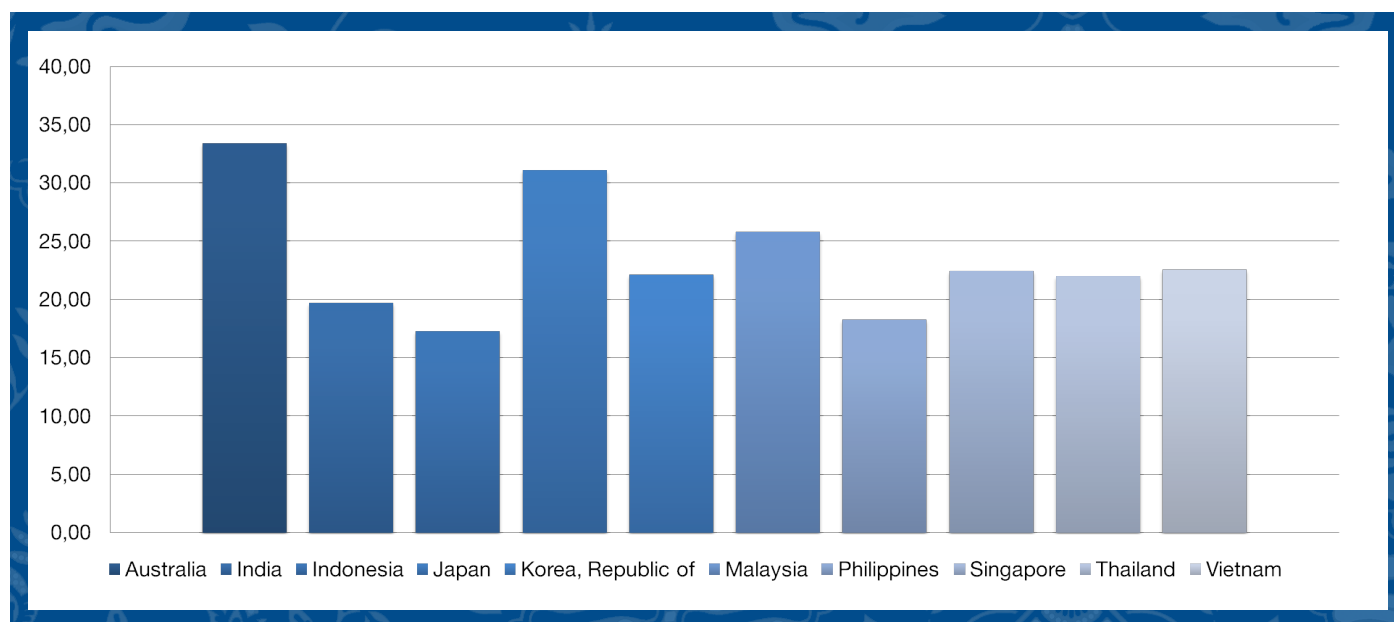
Figure 1. Government Revenue as a Percentage of GDP, Selected Countries, Year 2012
Source: IMF World Revenue Longitudinal Data, 2016.

As can be clearly seen above, developing countries like Indonesia, India, and the Philippines have the lowest government revenue as a proportion of their GDP. Relatively richer countries havea much higher proportion of revenue to GDP. The difference in tax intake of these countries are both a symptom and a cause of their level of development[2]. Relatively richer countries have better functioning tax administration systems than most developing countries and thus are able to collect proportionately larger taxes than most other countries, with Vietnambeing more the exception than the rule as it has a relatively more government-dominated economy than most other developing economies. Singapore, although the richest country in the ASEAN region by GDP per capita, has about the same tax intake as other developing countries, but this is partly due to the unique circumstances of Singapore as a high-functioning city-state with a famously lean government.

Countries like Indonesia and the Philippines do not have the luxury of being able to have such a lean government. First, both countries are archipelagos with thousands of islands each, and the extra spending required because of such a disjointed geographyare high.In small and dense Singapore, tax collection is relatively easy; conversely, in sparse and lower-income countries, tax collection isn't quite as efficient: the revenue from collecting taxes in a remote village in Vietnam may be lower than the costs of collecting it.

There is some evidence though, that poor people *are* taxed. Olken and Singhal (2011) found proof that-in Indonesia, the Philippines, and Vietnam-it is not uncommon for local governments to tax

2 The chart above shows government revenues rather than tax revenues, and therefore also includes grants and other non-tax revenues. The true difference in tax revenues between developed and developing countries are therefore higher than the chart suggests, as developing countries receives more aid and have a proportionally larger state-owned enterprise sector (which contribute to revenue) than developed economies.

poor people. The interesting finding though, is that the taxesare not necessarily paid with money. Some village governments are often told by district governments to do public projects without being given enough resources to do it. Thus, village heads often ask the relatively wealthy in the village to pay for the fees and appoint those who can't pay the fees to work on the project. The fact that at least those who work on the projects are payed is somewhat reassuring, but the unofficial way in which this project is financedrenders it unlikely to have a progressive net benefit.

The Problem of Informality: Taxing What's Not There

Other than the lack of an efficient centralized tax administration, a larger hurdle associated with tax collection in developing countries is the structure of employment. Developing countries have a higher percentage of its labor force in small family-run farms and in the informal sector compared to developed countries.This is also the case in ASEAN, where a non-representative survey by the ILO estimates that the percentage of the labor force employed in the non-agricultural informal sector ranges from 42% in Thailand to 72% in Indonesia[3]. This makes tax-collecting much harder in developing economies as family farms and informal businesses lack the capacity to record their business activities which a proper tax administration requires. From the point of view of the tax collector, not having proper (or any) accounting records is no different from not existing.

Does this mean that a push for formalization is required in middle-income ASEAN economies? Not if the goal is merely toincreaserevenue in the short term. There is little evidence that -in the short term-formalization of firms would bring a significant increase in revenue. Someevidence suggests that formalization of micro and small firms would only have a negligible impact on revenue as, again, small firms either do not have the requisite accounting facilities or are not very profitable anyway (Bruhn & McKenzie, 2014).

In the long-term though, formalization is good in and of itself. A firm with a business permit and financial recordswill have better access to credit and formal advertising and is thus in a better position to expand and improve than an informal firm. Rather than taxing small, newly formalized companies to pay corporate income taxes at rates imposed on large and established companies, governments can exempt them from corporate income taxes but require them only to pay sales taxes (which are easier to administer) until they reach a certain administrative capacity that enables them to pay income taxes.

This is obviously easier said than done, both administratively and in the designing of regulations that would incentivize businesses to formalize, but the untapped tax potential of small and informal businesses is too large for governments to pass over.

3 ILO. Statistical Update on Employment in the Informal Economy 2012. Retrieved from: http://laborsta.ilo.org/applv8/data/INFORMAL_ECONOMY/2012-06-Statistical%20update%20-%20v2.pdf

Income Taxes and its Discontents

Personal Income Taxes: A Nudging Approach?
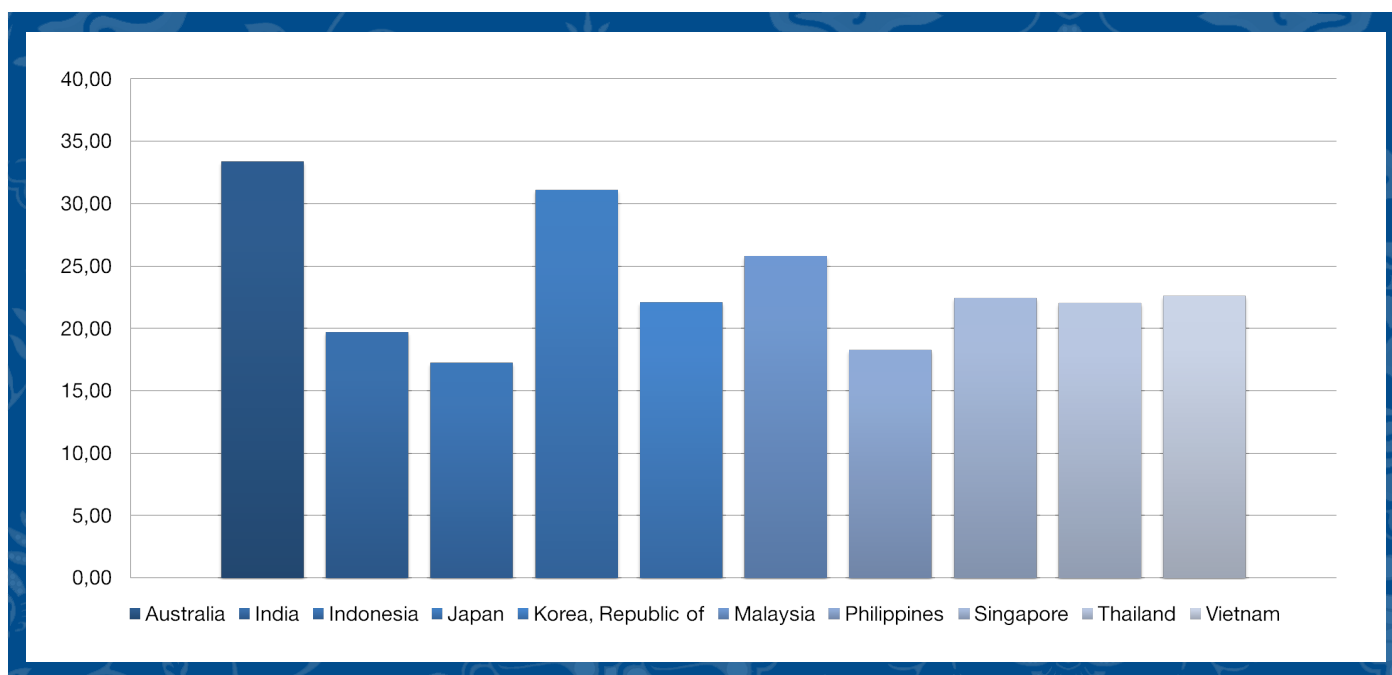
Figure 2. Personal Income Tax Revenue as a Proportion to Total Revenue, Year 2012
Source: IMF World Revenue Longitudinal Survey, 2016

Tax collection in the developing world is more of an art of achieving the possible rather than a scientific search of the optimal.

As can be seen above, developed countries rely much more on personal income taxes rather than developing countries[4].The reason why developing countries cannot rely on personal income taxes is that the majority of workers are either too poor to qualify for paying income taxes or, again, the lack of an efficient tax enforcement mechanism makes most workers not pay even if they do qualify for the income tax.

If some ASEAN governments are thinking of lowering personal income tax rates to boost economic growth (and thus raise revenues, indirectly) or if some others are considering to raise rates to extract as much possible from existing income but are afraid of the adverse consequences, a survey of the literature finds just as many research calling for lower tax rates to raise growth (e.g. Koester and Kormendi, 1989) as there are those saying that an increase in tax rates will not have a negative effect (e.g. Miller and Russek, 1997). If anything, the most convincing scientific article this author has read said that the effects of taxation is difficult to identify empirically(Easterly and Rebelo, 1993).

If the reader is partial to extracting more revenue out of existing income by raising rates but is afraid that a sudden increase in tax rates may have adverse consequences to productivity or savings behavior, then a more 'nudging' approach may be available. Preliminary evidence from the behavioral economics literature suggests that although people will shift behavior if there is a *sudden and*

4 Australia has a particularly high proportion of personal income tax to total revenue, because unlike most other countries, it does not rely on a separate social contribution scheme to finance its social insurance programs.

significant increase in their environment (in this case: tax rates), people tend not to change their behavior if the environment changes gradually (Ariely et al. 2003). If this approach has any political chance to be enacted, governments in ASEAN may want to consider raising tax rates gradually (by, say, a percentage point per year). The difficulty though is to not let prospective taxpayers get wind of the scheme.

Corporate Income Taxes: Hold Hands and Leap Together

This is quite worrying as most countries -developed or otherwise- are now racing to lower their corporate income tax rates so as to entice foreign firms to come to and invest in their countries. If countries like Indonesia, Vietnam, Thailand, and the Philippines try to lower corporate tax rates -which they are- then it runs the risk of lowering total revenues if it turns out that the lower revenues from the newly lowered rates is not offset by new revenues from either new foreign investment or newly formalized local businesses (who were enticed to formalize by the new tax rates).
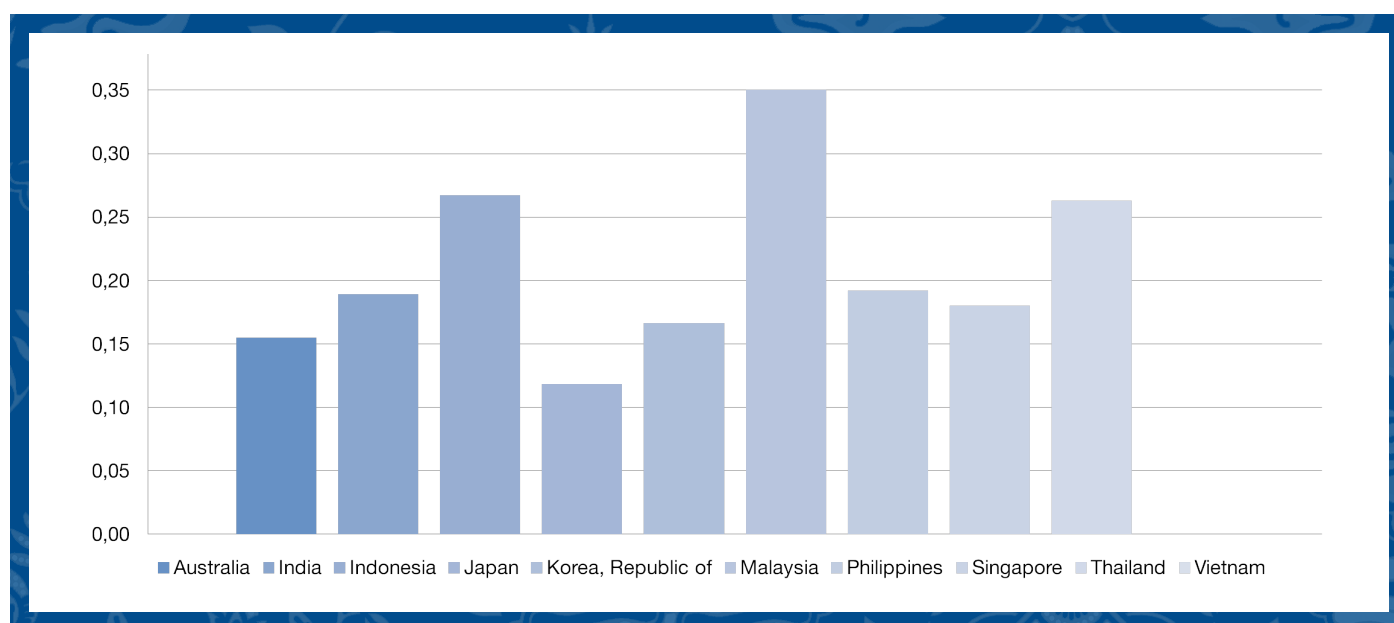
Figure 3. Corporate Income Taxes as a Proportion of Total Revenue, Year 2012

Source: IMF World Revenue Longitudinal Survey, 2016

Developing countries rely much more on corporate income taxes to finance their government, as it is much easier to collect from firms rather than individuals. Yet, as has been discussed above, most firms in developing countries are informal firms which pay little to no tax (at least officially). Thus the high proportion of revenue from corporate income taxes mean that developing countries are predominantly reliant on large, established firms to pay for running the country.

ASEAN governments would do well to remember that the corporate income taxis just one of many considerations a foreign company takes into account when deciding to invest. If ASEAN member states want to avoid an all-out race-to-the-bottom tax war among each other that ultimately benefits no one but large multi-national companies, it may be useful for the ASEAN to agree on a common minimum tax rate.

Other Things to Tax: Everything Else Under the Sun

In general, there are two ways to increase tax revenue: directly and indirectly. Indirect measures to increase revenues essentially mean boosting economic activities that are already taxed. All else equal, a bigger economy generates more tax revenue, at least in absolute terms, though not necessarly relative to the overall economy. The reader can find a multitude of papers -scientific or otherwise- that recommends ways to increase economic activity.

Direct efforts to increase revenues are another thing entirely. There are five principle ways to do so: (a). increasing the rates of existing taxes, (b). reducing tax exemptions and loopholes, (c). expanding the tax base, (d). improving the enforcement capacity of the tax administration and (e). levying new taxes.

We have already discussed the method (a) with regard to income taxes. Method (b) requires a much deeper knowledge of each country's taxation system and is outside the scope of this paper[5]. Method (c) and (d) is a darling of policy-makers worldwide and we have already reviewed some of the problems of these methods concerning the lack of resources on the part of the tax collectors and the difficulties of taxing the informal sector.

The most beguiling and yet rarely touched upon is method (e): finding new things to tax. We shall discuss just what other things we can tax.

5 At the risk of being excessively succinct, economists tend to agree that taxes should be 'neutral' i.e. it does not prefer one type of economic activity to another. The most egregious case of non-neutrality in ASEAN member states' tax code is the difference in tax rates between different types of income (labor, capital-gains, inheritance, etc.). This creates distortions in economic activity and unless there is a very good reason to be non-neutral (e.g. taxing cigarettes more than other goods for health reasons), it would generally be revenue-enhancing to avoid it.

Taxing Carbon: Killing Political Careers while Saving the Planet

This author admits that the idea of carbon taxation is the very epitome of a political non-starter. There were widespread protests in Indonesia when fuel *subsidies* were cut, but now this author shall propose that taxing fuel and other greenhouse gas emitting substancesis beneficial. As of this writing, there is a total of fourteen jurisdictions across the world that levy a carbon tax and some others have already implemented some form of emissions trading (which can be thought as an implicit tax), including China. None of the ASEAN countries have yet to apply it however.

The case for carbon taxes is strong. Without getting into the details of how climate change works, the greenhouse gases that the world emits create a plethora of economic threats which include property damage (through extreme weather), health risks, and reduced agricultural productivity. To use a bit of jargon: a carbon tax would be a Pigouvian tax that internalizes the costs of carbon directly into the price of the activity that produces it.

Monitoring emissions is not easy though, especially for greenhouse gases other than carbon. Ideally, a carbon tax would tax each type of gas according to the damage each of it creates. If monitoring emissions werenot difficult enough, it is even more difficult to properly assess the potential damage that each type of gas confers to society. To the best of this author's knowledge, there exists no rigorous econometric model to assess the monetary-equivalent costs of environmental degradation.

On top of the difficulty of taxing carbon optimally, if one were to tax carbon too high, there is a large risk that it would *decrease* tax revenues rather than increase it. Lower and middle-income countries in the ASEAN region relies heavily on products that create greenhouse gases. After taking into

consideration the interaction between carbon emitting economic activities and the reliance of our economies on carbon, a sufficiently high carbon tax would undoubtedly increase all other prices, put proportionately more burden on the poor, reduce profits of many companies, decrease employment, and reduce economic growth. This is why carbon taxes is such a political non-starter.

Yet, considering the environmental costs of climate change, a carbon tax will have to be done sooner or later in order to finance the extra revenue needed to combat the effects of climate change that is already happening. ASEAN governments have leeway to experiment what they think is the best way to raise revenues from carbon. Continuing with ASEAN's theme of doing everything slowly but surely, it is not inconceivable to tax fuel prices a small percentage at first and then gradually increase the rates so as to give the economy ample time to adjust to the new policy.

Bank Liabilities Tax: Also, a Half-Baked Proposal to Avert the Next Crisis

There are many names for this proposal: bank levies, bank taxes, balance sheet taxes, bank liabilities taxes. Essentially this is a tax on the balance sheet of banks, specifically their liabilities. This proposal was first brought forth by the IMF soon after the global financial crisis. This proposal also has the added bonus of strengthening banks' balance sheets.

When banks, or any other financial institution get into trouble, it is almost always because they have too much liabilities. When their debt is large, a seemingly small reduction in asset value caused by any negative shock can have large repercussions on their ability to pay said debt. The reason why banks are prone to hold large amounts of debt can partly be explained by the perverse incentives that the current tax code creates. Banks, like all other corporations, pay corporate income taxes. When corporations borrow money, the interest expense from that debt can be deducted from taxes and thus increase their after-tax profits. Thus, it is in the interest of banks to finance their activities through debt rather than equity.

Governments around the world usually have a morass of regulations to try make banks reduce risky activities and also make banks keep a sufficiently large capital-cushion in order to prevent debt crises. Because of these notoriously complex regulations, both banks and the governments require large amounts of money and manpower to ensure that these regulations are followed. Yet, financial crises still happen[6].

A bank tax that levies a sufficiently high cost on banks' liabilities would naturally shift the preference for banks to hold on to capital rather than debt. In fact, it is not inconceivable to remove corporate income taxes for banks altogether and just require them to pay bank levies. To further align the incentives of banks with regulators, it may also be possible to charge different rates for different types of debt according to their risk profiles. This proposal would obviously require a massive change in the regulatory code and how that new code would enact the transition from one system of taxation to another would be very interesting -if risky- to behold.

6 A summary of the causes of the 1997 financial crisis: Thai, Malaysian, and Indonesian banks (and corporations in general) had too much debt in their balance sheets; when a trade shock in Thailand resulted in a depreciation of the Bath, this reduced the value of the asset side of their balance sheet which (after much in between) then ended in the largest financial crisis the Southeast Asian economies has faced. Banking regulations in ASEAN has not changed very much since that time.

Summary and Conclusion

This issue of ASEAN Briefs has attempted to explain the nuanced hurdles middle-income ASEAN economies face to increase their tax revenues. The lack of a centralized and efficient tax administration mechanism still leaves a large part of the economy untaxed, or at least taxed informally (and presumably inefficiently). Even if such an efficient mechanism were to exist, middle-income economies are still dominated by workers in small-scale family farms and the rest of the informal sector. A push for formalization may result in higher productivity and thus revenues in the long term, but creating the incentives for formalization is not easy to do.

The tax structure of middle-income ASEAN economies still relies on the income taxes of large corporations. The race to lower corporate income tax rates between ASEAN economies are misguided and may result in reduced tax revenues with no effect on investment if there is no agreement between countries to outcompete each other. Personal income taxes rates may be raised without distorting incentives too much(especially rates at the top income bracket) as long as the rate increase takes a sufficiently slow pace.

New taxes may be levied, but they are not without its risks. A carbon tax may help in fighting the effects of climate change while adding to revenue, but short and long term interests must be balanced to minimize the adverse effects of taxing carbon, which is one the most essential (by-)products of any economy. This is especially true for economies that rely on exporting various types of bio- and fossil fuels like Indonesia and Malaysia.

Bank taxes can also be levied that target risky liabilities on banks' balance sheets. But such a tax exists in concept only and the nitty-gritty details of how to enact such a tax, which would require a major transition of how banks operate, may be fraught with its own difficulties.

The policies proposed here are only preliminary recommendations. The particularities of how it should be implemented can be a platform within which governments must experiment and find for themselves their optimal point. If there is anything concrete the reader should take away from this brief, it is that everything can be taxed, just not by too much.

Finally, if such revenue-enhancing proposals were to fail (either in proposal or in practice), we can always finance the government through larger deficits.

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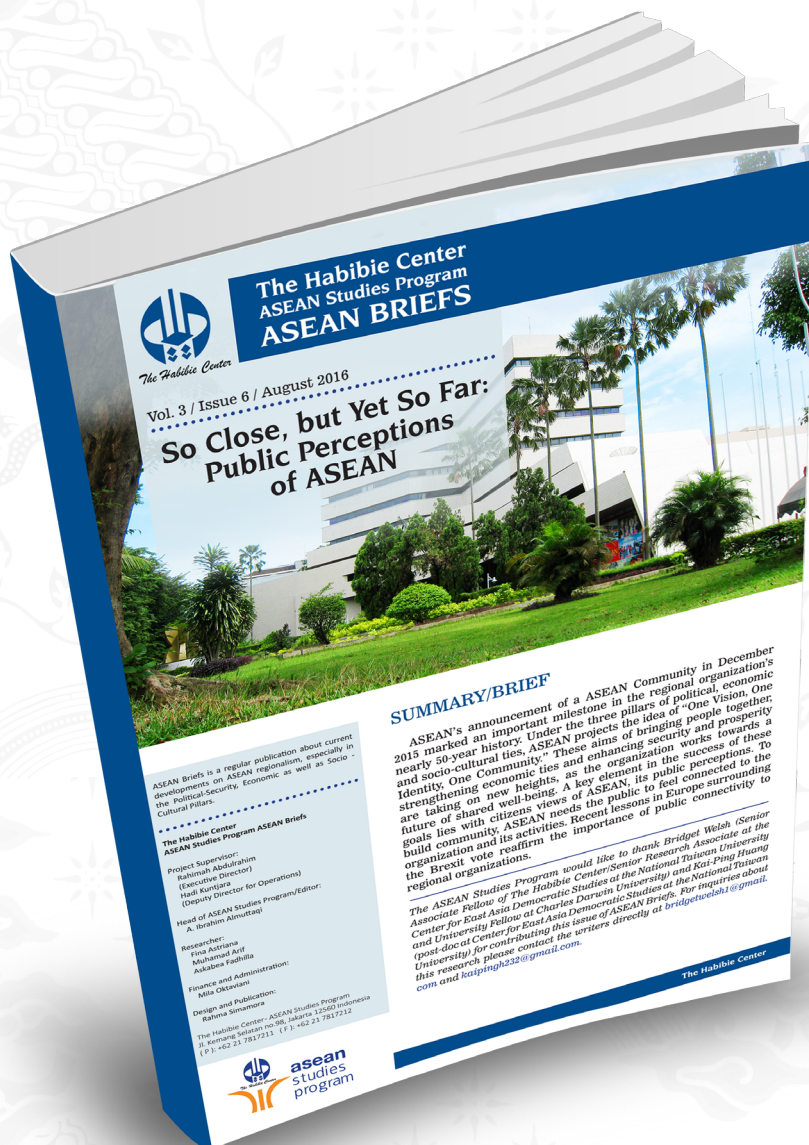
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The ASEAN Studies Program was established on February 24, 2010, to become a center of excellence on ASEAN related issues, which can assist in the development of the ASEAN Community by 2015. The Habibie Center through its ASEAN Studies Program, alongside other institutions working towards the same goal, hopes to contribute to the realization of a more people-oriented ASEAN that puts a high value on democracy and human rights. The objective of the ASEAN Studies Program is not merely only to conduct research and discussion within academic and government circles, but also to strengthen public awareness by forming a strong network of civil society in the region that will be able to help spread the ASEAN message. With the establishment of ASEAN Studies Program, The Habibie Center aims to play its part within our capabilities to the ASEAN regional development.

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Talking ASEAN is a monthly public dialogue held at The Habibie Center in Jakarta. Covering a wide array of issues related to ASEAN, Talking ASEAN addresses topics of: Economic Integration, Socio-cultural, & Democracy, human rights and regional peace, among others. Featuring local and visiting experts, Talking ASEAN is one of a series of twelve dialogues regularly held each month and open to a target audience consisting of ASEAN officials, foreign ambassadors & diplomats, academics, university students, businesses, and the media.

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